

TEXAS 562

**VALLEY TELEPHONE COOPERATIVE, INC.
RAYMONDVILLE, TEXAS**

**CONSOLIDATED FINANCIAL STATEMENTS
AND SUPPLEMENTARY INFORMATION**

**As of December 31, 2011 and 2010
With Independent Auditor's Report**

**TEXAS 562
VALLEY TELEPHONE COOPERATIVE, INC.
RAYMONDVILLE, TEXAS**

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Independent Auditor's Report

**The Board of Directors
Valley Telephone Cooperative, Inc.
Raymondville, Texas**

We have audited the accompanying consolidated balance sheets of Valley Telephone Cooperative, Inc. (a Texas corporation), as of December 31, 2011 and 2010, and the related consolidated statements of operations, accumulated other comprehensive income and changes in members' equity, and cash flows for the years then ended. These consolidated financial statements are the responsibility of the Cooperative's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Cooperative's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Valley Telephone Cooperative, Inc., as of December 31, 2011 and 2010, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued a report dated March 20, 2012, on our consideration of Valley Telephone Cooperative, Inc.'s internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing and internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

Our audit was conducted for the purpose of forming opinions on the financial statements taken as a whole. The consolidating balance sheets, statements of operations, and cash flows on pages 25 through 32, are presented for purposes of additional analysis and are not a required part of the financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the financial statements. The information has been subjected to the auditing procedures applied in the audit of the financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the financial statements or to the financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, except for the effects on the VTCI/VTXT Consolidating Statements of Operation and Cash Flows of not including equity in the earnings of a subsidiary excluded from the VTCI/VTXT consolidation, the information is fairly stated, in all material respects, in relation to the financial statements as a whole.

Curtis Blahely & Co, P.C.

Longview, Texas

March 20, 2012

VALLEY TELEPHONE COOPERATIVE, INC.
CONSOLIDATED BALANCE SHEETS
December 31

| Assets | | |
|--|------------------------------|------------------------------|
| | <u>2011</u> | <u>2010</u> |
| Current Assets: | | |
| Cash and cash equivalents | \$ 8,706,964 | \$ 6,692,147 |
| Telecommunications accounts receivable (net of allowance for doubtful accounts of \$312,150 and \$253,911) | 530,183 | 566,654 |
| Other receivables (net of allowance for doubtful accounts of \$466,367 and \$468,605) | 3,107,965 | 2,319,996 |
| Accrued unbilled revenue | 31,024 | 71,024 |
| Materials and supplies | 5,557,652 | 6,401,875 |
| Deferred tax asset | 239,998 | 194,968 |
| Prepayments | <u>1,013,776</u> | <u>1,333,441</u> |
| Total Current Assets | <u>19,187,562</u> | <u>17,580,105</u> |
| Property, Plant, and Equipment: | | |
| Plant in service | 164,846,625 | 163,569,105 |
| Plant under construction | <u>41,882,777</u> | <u>12,876,478</u> |
| Total Property, Plant, and Equipment | 206,729,402 | 176,445,583 |
| Less: Accumulated depreciation | <u>93,304,922</u> | <u>95,013,120</u> |
| Net Property, Plant, and Equipment | <u>113,424,480</u> | <u>81,432,463</u> |
| Investments and Other Assets: | | |
| Investment in cellular entities | 22,556,668 | 21,838,669 |
| Other assets | 321,213 | 468,086 |
| Intangibles | <u>485,984</u> | <u>692,234</u> |
| Total Investments and Other Assets | <u>23,363,865</u> | <u>22,998,989</u> |
| Total Assets | <u>\$ 155,975,907</u> | <u>\$ 122,011,557</u> |

(The accompanying notes are an integral part of these consolidated financial statements.)

VALLEY TELEPHONE COOPERATIVE, INC.
CONSOLIDATED BALANCE SHEETS
December 31

| Liabilities and Equity | | |
|--|------------------------------|------------------------------|
| | <u>2011</u> | <u>2010</u> |
| Current Liabilities: | | |
| Current maturities of long-term debt | \$ 1,891,190 | \$ 1,418,519 |
| Accounts payable | 9,733,250 | 2,455,928 |
| Advance billing | 521,066 | 761,997 |
| Patronage capital credits payable | 682,381 | 848,751 |
| Accrued income taxes | 62,454 | 46,725 |
| Other accrued liabilities | 1,071,866 | 757,649 |
| Customer deposits | <u>23,663</u> | <u>27,433</u> |
| Total Current Liabilities | <u>13,985,870</u> | <u>6,317,002</u> |
| Long-Term Debt, Less Current Maturities: | | |
| RUS notes | 25,199,023 | 13,932,025 |
| Capital leases | <u>28,817</u> | <u>55,702</u> |
| Total Long-Term Debt, Less Current Maturities | <u>25,227,840</u> | <u>13,987,727</u> |
| Other Liabilities: | | |
| Deferred revenue | 17,811,657 | 4,465,577 |
| Deferred income taxes | 6,795,008 | 6,786,030 |
| Share of deficiency of assets of LLCs | 5,235,275 | 5,542,919 |
| Accrued postretirement benefits | <u>7,910,720</u> | <u>6,831,484</u> |
| Total Other Liabilities | <u>37,752,660</u> | <u>23,626,010</u> |
| Members' Equity: | | |
| Retained margin | 57,850,020 | 57,719,112 |
| Patronage capital assigned | 22,413,618 | 22,014,462 |
| Patronage capital assignable | 2,895,995 | 1,788,306 |
| Accumulated other comprehensive income: | | |
| Unrecognized postretirement benefit costs | <u>(4,150,096)</u> | <u>(3,441,062)</u> |
| Total Members' Equity | <u>79,009,537</u> | <u>78,080,818</u> |
| Total Liabilities and Equity | <u>\$ 155,975,907</u> | <u>\$ 122,011,557</u> |

(The accompanying notes are an integral part of these consolidated financial statements.)

VALLEY TELEPHONE COOPERATIVE, INC.
CONSOLIDATED STATEMENTS OF OPERATIONS
For the Years Ended December 31

| | <u>2011</u> | <u>2010</u> |
|---------------------------------------|---------------------|---------------------|
| Operating Revenues: | | |
| Local network services | \$ 1,360,110 | \$ 1,299,975 |
| Network access services | 20,586,333 | 18,565,600 |
| Long distance network services | 767,493 | 830,181 |
| Internet and video services | 4,594,253 | 3,926,876 |
| Transport services | 3,716,334 | 3,574,181 |
| Grant revenue | 5,975 | -0- |
| Miscellaneous | 533,650 | 560,272 |
| Uncollectibles | (144,853) | (136,451) |
| Total Operating Revenues | <u>31,419,295</u> | <u>28,620,634</u> |
| Operating Expenses: | | |
| Plant specific operations | 7,276,172 | 7,250,021 |
| Plant nonspecific operations | 6,527,178 | 5,648,072 |
| Depreciation and amortization | 9,090,657 | 7,820,623 |
| Customer operations | 2,259,960 | 2,140,889 |
| Corporate operations | 5,926,478 | 6,090,205 |
| Write-down of assets | 7,315,297 | -0- |
| Total Operating Expenses | <u>38,395,742</u> | <u>28,949,810</u> |
| Operating Taxes: | | |
| Income tax benefit | (3,512,948) | (1,087,775) |
| Other operating taxes | 895,565 | 854,721 |
| Total Operating Taxes | <u>(2,617,383)</u> | <u>(233,054)</u> |
| Operating Margin | <u>(4,359,064)</u> | <u>(96,122)</u> |
| Nonoperating Income (Expense): | | |
| Interest and investment income | 2,632 | 4,412 |
| Share of cellular entities' earnings | 13,540,926 | 13,608,234 |
| Other nonoperating income | (24,298) | 34,439 |
| Income tax expense | (4,645,791) | (4,608,982) |
| Total Nonoperating Margin | <u>8,873,469</u> | <u>9,038,103</u> |
| Margin Before Interest Charges | <u>4,514,405</u> | <u>8,941,981</u> |
| Interest Charges: | | |
| Interest on long-term debt | 904,189 | 659,970 |
| Other interest | 46,973 | 6,560 |
| Capitalized interest | (716,195) | (297,290) |
| Total Interest Charges | <u>234,967</u> | <u>369,240</u> |
| Net Margin | <u>\$ 4,279,438</u> | <u>\$ 8,572,741</u> |

(The accompanying notes are an integral part of these consolidated financial statements.)

VALLEY TELEPHONE COOPERATIVE, INC.
CONSOLIDATED STATEMENTS OF ACCUMULATED OTHER COMPREHENSIVE INCOME
AND CHANGES IN MEMBERS' EQUITY
For the Years Ended December 31

| | Accumulated Other Comprehensive Income | |
|---|---|-----------------------|
| | 2011 | 2010 |
| Balance, January 1 | \$ (3,441,062) | \$ (3,472,192) |
| Net Margin | \$ 4,279,438 | \$ 8,572,741 |
| Postretirement health plan adjustment, net of income tax of \$(163,365) and \$163,365 | <u>(709,034)</u> | <u>31,130</u> |
| Comprehensive Income | \$ <u>3,570,404</u> | \$ <u>8,603,871</u> |
| Balance, December 31 | \$ <u>(4,150,096)</u> | \$ <u>(3,441,062)</u> |

| | 2011 Margin | | 2010 Margin | |
|-------------------------------|------------------------|----------------------|------------------------|----------------------|
| | Operating | Nonoperating | Operating | Nonoperating |
| Balance, Beginning of Period | \$ -0- | \$ 57,719,112 | \$ -0- | \$ 51,328,507 |
| Net margin | 2,993,834 | 1,285,604 | 1,779,993 | 6,792,748 |
| Transfer to patronage capital | (2,993,834) | (554,111) | (1,779,993) | (1,373,903) |
| Retirements and other changes | <u>-0-</u> | <u>(600,585)</u> | <u>-0-</u> | <u>971,760</u> |
| Balance, End of Period | \$ <u>-0-</u> | \$ <u>57,850,020</u> | \$ <u>-0-</u> | \$ <u>57,719,112</u> |

| | 2011 Patronage Capital | | 2010 Patronage Capital | |
|------------------------------|-----------------------------------|----------------------|-----------------------------------|----------------------|
| | Assignable | Assigned | Assignable | Assigned |
| Balance, Beginning of Period | \$ 1,788,306 | \$ 22,014,462 | \$ 2,049,562 | \$ 21,112,856 |
| Transfer of margins | 3,547,945 | -0- | 3,153,896 | -0- |
| Capital credits assigned | (2,443,502) | 2,443,502 | (3,418,711) | 3,418,711 |
| Capital credits retired | -0- | (2,044,346) | -0- | (2,517,105) |
| Federal excise tax refund | <u>3,246</u> | <u>-0-</u> | <u>3,559</u> | <u>-0-</u> |
| Balance, End of Period | \$ <u>2,895,995</u> | \$ <u>22,413,618</u> | \$ <u>1,788,306</u> | \$ <u>22,014,462</u> |

(The accompanying notes are an integral part of these consolidated financial statements.)

VALLEY TELEPHONE COOPERATIVE, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
For the Years Ended December 31

| | <u>2011</u> | <u>2010</u> |
|--|---------------------|---------------------|
| Cash Flows from Operating Activities: | | |
| Net margin | \$ 4,279,438 | \$ 8,572,741 |
| Adjustments to reconcile net margin to net cash provided by operating activities: | | |
| Depreciation and amortization | 9,090,657 | 7,820,623 |
| Share of cellular entities earnings | (13,540,926) | (13,608,234) |
| Distributions from cellular entities | 12,515,283 | 11,517,337 |
| Loss on sale and write-down of plant | 7,339,667 | -0- |
| Capital certificates received | (33,398) | (21,568) |
| Amortization of deferred grant revenue | (5,975) | -0- |
| Change in assets and liabilities: | | |
| Accounts receivable | (711,499) | 218,486 |
| Prepays | 319,665 | (1,039,039) |
| Other assets | 375,241 | (223,564) |
| Accounts payable and accruals | 593,287 | 481,448 |
| Deferred credits | (569,858) | 1,361,468 |
| Total Adjustments | <u>15,372,144</u> | <u>6,506,957</u> |
| Net Cash Provided by Operating Activities | <u>19,651,582</u> | <u>15,079,698</u> |
| Cash Flows from Investing Activities: | | |
| Capital expenditures | (40,232,384) | (21,217,623) |
| Cash Flows from Financing Activities: | | |
| Payments of long-term debt | (1,492,044) | (1,771,053) |
| RUS loan advances | 13,204,828 | 1,918,319 |
| Grant proceeds | 13,690,891 | 2,110,653 |
| Proceeds from line-of-credit | 750,000 | -0- |
| Payments on line-of-credit | (750,000) | -0- |
| Capital credits paid | (2,811,303) | (2,373,191) |
| Excise tax refund received | <u>3,247</u> | <u>3,559</u> |
| Net Cash Provided by (Used in) Financing Activities | <u>22,595,619</u> | <u>(111,713)</u> |
| Net Increase (Decrease) in Cash and Cash Equivalents | 2,014,817 | (6,249,638) |
| Cash and Cash Equivalents at Beginning of Year | <u>6,692,147</u> | <u>12,941,785</u> |
| Cash and Cash Equivalents at End of Year | <u>\$ 8,706,964</u> | <u>\$ 6,692,147</u> |

(The accompanying notes are an integral part of these consolidated financial statements.)

**VALLEY TELEPHONE COOPERATIVE, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2011**

Note 1 – Summary of Significant Accounting Policies:

Basis of Presentation

In this report, Valley Telephone Cooperative, Inc. (VTCI) and its subsidiaries, VTX Communications, LLC (VTXC), VTX Investments, LLC (VTXI) and VTX Telecom, LLC (VTXT) are collectively referred to as the "Cooperative" or "we".

We are a nonpublic, member owned cooperative that serves as an incumbent local exchange carrier providing regulated landline telecommunications services in rural areas of South Texas. We are regulated by the Public Utility Commission of Texas (PUC) and follow the Uniform System of Accounts prescribed by the Federal Communications Commission (FCC) with additional guidance and interpretations from the Rural Utilities Service (RUS) and U.S. Department of Agriculture. Our regulated telephone operations are subject to the provisions of FASC Topic 980 – Regulated Operations, which requires the recognition of the economic effects of rate regulation. Accordingly, FASC Topic 980 requires us to depreciate telephone plant and equipment over useful lives as approved by regulators, which could be longer than the useful lives that would otherwise be determined by our management. FASC Topic 980 also requires deferral of certain costs and obligations based upon approvals received from regulators to permit recovery of such amounts in the future. We continually review the applicability of FASC Topic 980 based upon the developments in the current regulatory and competitive environment. If we were to discontinue the application of FASC Topic 980, we would be required to write-off our regulatory assets and liabilities and would be required to adjust the carrying value of any property, plant, and equipment that would be deemed unrecoverable. We believe we continue to meet the criteria for accounting under FASC Topic 980 and that the carrying value of our property, plant, and equipment is recoverable in compliance with the Uniform System of Accounts prescribed by the FCC.

The consolidated financial statements include the accounts of VTCI and its wholly-owned subsidiaries. VTXC's principal activity is the provision of transport services to other carriers, long distance services to residences and businesses, wholesale internet service and internet protocol video service. VTXI owns interests in three LLCs formed in a tower leasing arrangement and three limited partnerships that operate cellular mobile telecommunications systems in South Texas. VTXT provides competitive local exchange service in South Texas.

All significant intercompany transactions are eliminated in the consolidation process. Investments in entities which we do not control but have the ability to exercise significant influence, such as, the cellular partnerships and limited liability companies, are accounted for under the equity method.

The preparation of financial statements in conformity with generally accepted accounting principles (GAAP) requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from these estimates. Significant estimates that are reasonably possible to change in the near term include the allowance for bad debts, postretirement benefit accrual, interstate revenues from settlements, and income from equity method investments.

Certain reclassifications of the prior year's data have been made to conform to the current year's classification.

Accounts Receivable

Telecommunications and other trade receivables are reported in the balance sheet at outstanding principal less any allowances for doubtful accounts. Trade receivables are short-term and interest is not accrued. Telecommunications receivables are written off after the customer has been disconnected for at least ninety days. Other trade receivables are written off at the time they are deemed uncollectible. An allowance for telecommunications and other trade receivables is recorded when deemed appropriate based on a review of aged receivables and expected recoveries.

VALLEY TELEPHONE COOPERATIVE, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2011

Note 1 – Summary of Significant Accounting Policies: (continued)

Property, Plant, and Equipment

Telephone plant is stated substantially at original cost. Additions, replacements, and renewals of property determined to be units of property are charged to telephone plant accounts. The replacement of plant determined not to be a unit of property and the cost of maintenance and repairs are charged to operating expense. Normal retirements are charged in total to the accumulated depreciation accounts along with the cost of removal, less salvage, with no gain or loss recognized. Non-telephone property is stated at cost and, when sold or retired, a gain or loss is recognized. Depreciation expense is computed using straight-line rates determined by estimated service lives and salvage amounts of various groups of depreciable property. These group rates are applied to account balances, vintage years, and individual items in calculating depreciation expense. The service lives of the regulated property are approved by the PUC.

As discussed elsewhere in these footnotes, we received Broadband Initiative Program (BIP) and Broadband Technology Opportunities Program (BTOP) awards during 2010 and 2011. The BTOP funds must be expended for approved projects within three years of execution of the agreements which deadline will be in the latter part of 2013. The BIP award funds must be expended by June 30, 2015. The purpose of the BIP award is for VTXT to develop infrastructure in eleven unserved and underserved rural communities of the South Texas Plains. The BTOP award provides funds to VTXC for the construction of broadband facilities connecting five anchor institutions. All assets purchased or constructed using grant, loan or internal funds are recorded at cost and depreciated using our normal depreciable lives and methods.

Property, plant, and equipment are reviewed for impairment whenever events or circumstances indicate their carrying value may not be recoverable. When such events or circumstances arise, an estimate of the future undiscounted cash flows produced by the asset, or the appropriate grouping of assets, is compared to the asset's carrying value to determine if any impairment exists pursuant to the requirements of FASC Topic 360 – Property, Plant & Equipment. If the asset is determined to be impaired, the impairment loss is measured based on the excess of its carrying value over its fair value.

Intangible Assets

We do not amortize “indefinite lived” intangibles but test them for impairment according to the requirements of FASC Topic 350 – Intangibles—Goodwill and Other. Intangibles determined to have finite lives are amortized. These amortizable intangibles are reviewed for impairment in accordance with FASC Topic 360.

A significant portion of our intangible assets are wireless licenses that provide us with the exclusive right to utilize designated radio frequency spectrum. While licenses are issued for only a fixed time, generally ten years, such licenses are subject to renewal by the FCC. Renewals of licenses have occurred routinely and at nominal cost. Moreover, we have determined that there are currently no legal, regulatory, contractual, competitive, economic or other factors that limit the useful life of our wireless licenses. As a result, we treat the wireless licenses as an indefinite-lived intangible asset under the provisions of FASC Topic 350. We reevaluate the useful life determination for wireless licenses each reporting period to determine whether events and circumstances continue to support an indefinite useful life. Costs to renew licenses are expensed in the period incurred.

Internal Use Software

We capitalize software developed or obtained for internal use. These capitalized costs are included in property, plant, and equipment. Initial operating system software is amortized over the life of the associated hardware. Application software is amortized over a useful life of three years.

VALLEY TELEPHONE COOPERATIVE, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2011

Note 1 – Summary of Significant Accounting Policies: (continued)

Income Taxes

As an organization formed under IRC Section 501(c)(12), VTCI must receive 85 percent of its gross income from members to be tax exempt. In 2011, VTCI did not receive at least 85 percent of its gross income from members thus subjecting its interest and miscellaneous income to federal taxation. VTCI is allowed a patronage exclusion whereby its patronage sourced income is excluded from taxable income.

VTXC elects taxation as a C Corporation and, as such, will be included in the consolidated tax return of VTCI. VTXI and VTXI are disregarded entities for federal tax purposes and are treated as divisions of VTCI and VTXC, respectively, for federal tax reporting.

The State of Texas franchise tax is an income tax based on modified gross revenue and referred to as the Margin Tax. All of the entities in the consolidated group are subject to the Margin Tax except for VTCI.

Deferred income taxes are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred income tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The major temporary differences that give rise to the net deferred tax liability are differences in the bases of partnership investments and differences for financial and income tax reporting in the depreciable basis, methods and lives of property, plant, and equipment. The grant proceeds received are not recognized as income for tax purposes but reduce the depreciable basis of assets acquired with the funds.

“Accounting for Uncertainty in Income Taxes” contained in FASC Topic 740 – Income Taxes requires the use of a two-step approach for recognizing and measuring tax benefits taken or expected to be taken in a tax return and disclosures regarding uncertainties in income tax positions. The first step is recognition: we determine whether it is more likely than not that a tax position will be sustained upon examination, including resolution of any related appeals or litigation processes, based on the technical merits of the position. In evaluating whether a tax position has met the more-likely-than-not recognition threshold, we presume that the position will be examined by the appropriate taxing authority that has full knowledge of all relevant information. The second step is measurement: a tax position that meets the more-likely-than-not recognition threshold is measured to determine the amount of benefit to recognize in the financial statements. The tax position is measured at the largest amount of benefit that is greater than 50 percent likely of being realized upon ultimate settlement. Differences between tax positions taken in a tax return and amounts recognized in the financial statements will generally result in one or more of the following: an increase in a liability for income taxes payable, a reduction of an income tax refund receivable, a reduction in a deferred tax asset, or an increase in a deferred tax liability. We have not identified any uncertain tax positions requiring adjustment or disclosure.

Postretirement Benefits Other Than Pensions

In accordance with FASC Topic 715 – Compensation-Retirement Benefits, postretirement health care benefits earned during the year as well as interest on projected benefit obligations are accrued currently. Actuarial gains and losses and prior service costs and credits resulting from changes in plan benefits are amortized over the average remaining service period of the employees expected to receive benefits. We report the current economic status (the overfunded or underfunded status) of the plan in our balance sheet, measure the plan assets and plan obligations as of the balance sheet date, and include enhanced disclosures about the plan. We recognize, through comprehensive income, changes in the funded status in the year that the changes occur.

VALLEY TELEPHONE COOPERATIVE, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2011

Note 1 – Summary of Significant Accounting Policies: (continued)

Comprehensive Income

We follow the guidance of FASC 220 - Comprehensive Income. FASC 220 requires the reporting and display of other comprehensive income items which are items that are recorded directly to equity and are not included in net income. Our only other comprehensive income item is the adjustment for the overfunded or underfunded status of our postretirement benefit plan required by FASC Topic 715.

Revenue Recognition

Revenues are recognized in the period services are provided. We participate in a revenue sharing arrangement with other telephone companies for interstate revenue. This arrangement includes cost based settlements and a federal universal service fund. Revenues earned through the sharing arrangement are initially recorded based on our estimates. Actual interstate revenues are not known until settlement studies are conducted. We bill and keep intrastate access and long distance revenues. We also receive fixed monthly per access line amounts from the Texas Universal Service Fund (TUSF).

Revenues derived from local telephone service, Internet services, video services and special access (principally fixed fees) are billed monthly in advance and are recognized the following month when services are provided. Other revenues derived from telecommunications services, principally long-distance, and network access, are recognized monthly as services are provided. Other products and services revenue are recognized when products are delivered and accepted by customers and when services are provided. We also sell capacity on our network to other telecommunication providers. Sales of capacity are accounted for as either operating leases or service agreements depending upon the terms of the transaction and revenue is recognized ratably over the term of the agreement.

We have separate prices for the services described above but we also bundle these services into various service packages. During 2010, we adopted Accounting Standards Update (ASU) 2009-13 – Multiple-Deliverable Revenue Arrangements, which is codified as FASC Topic 605-25. This ASU provides the accounting guidance for our bundled service (multiple-deliverable) arrangements. Our multiple-deliverable arrangements are generally provided at a price below the amount determined on a separate basis. This discount is allocated to the non-tariff service items based on their separate selling prices. All of the services in a package qualify as separate units of accounting. All services are provided and recognized monthly, therefore, the allocation to specific units does not have a material impact on the timing of revenue recognition.

Installation fees do not have value to the customer on a stand-alone basis and are therefore not units of accounting. We recognize revenue from installation fees in the period that the fees are billed rather than amortizing them over the average customer life. The fees are consistent in amount and accounted for consistently so the effect of recognizing revenue in the period billed rather than amortizing is immaterial. Also, costs associated with most installations are expensed when incurred which provides period matching with the revenue.

The adoption of ASU 2009-13 did not cause significant changes in how we identify accounting units, the allocation of consideration to those units, or the pattern and timing of revenue recognition. We do not expect the adoption of ASU 2009-13 to have a material effect on financial statements of future periods.

VALLEY TELEPHONE COOPERATIVE, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2011

Note 1 – Summary of Significant Accounting Policies: (continued)

Beginning in 2010, we receive grant funds from RUS and the National Telecommunications and Information Administration (NTIA) as part of the BIP and BTOP. The total BIP grant award is \$38,520,868 and the BTOP grant award is \$15,697,856. The BIP award also includes \$40,093,153 of loan funds and BTOP requires that we expend \$6,727,653 of our own funds. The total grant funds received in 2011 and 2010 under both programs was \$13,690,891 and \$2,133,473, respectively. Grant funds are initially recorded as deferred revenue and will be recognized as revenue ratably over the useful life of the assets purchased or constructed using the funds. In 2010, the only grant funded asset placed in services was land, for which revenue is recognized based on the life of assets placed on the land. Therefore, no grant revenue was recognized in 2010. In 2010, we applied \$22,820 of grant funds to pre-application expenses which was recorded as a reduction of expense. This left a balance in deferred grant revenue of \$2,110,653 at December 31, 2010. In 2011, a small portion of the grant funded assets were placed in service and \$5,975 of grant revenue has been recognized in 2011, leaving a deferred grant revenue balance of \$15,795,569.

We collect taxes from various taxing authorities on certain types of revenue producing transactions. It is our position that we are acting strictly as an agent for the taxing authority, whereby, the tax is collected and remitted to the taxing entity. Using the net method to account for these taxes, we do not record the taxes as a revenue or expense.

Materials and Supplies

Materials and supplies are carried principally at average original cost.

Patronage Capital

We operate on a nonprofit basis. Amounts received from the furnishing of telephone service in excess of operating costs and expenses are assigned to telephone patrons on a patronage basis. Amounts received from interest income and other sources (sale, lease and maintenance of nonregulated telephone plant) in excess of costs and expenses are also allocated to telephone patrons on a patronage basis. Profits of the subsidiaries may be retained or allocated depending upon the board of directors' determination of capital requirements.

Unclaimed capital credit payments from previous patronage retirements are carried in a payable account for three years. After three years, if efforts to locate patrons are unsuccessful, the unclaimed property is reclassified to permanent capital in accordance with agreements with our patrons. The reclassification to permanent capital or subsequent payments from permanent capital to members or to the State of Texas are reported as retirements and other changes to margin in the Statement of Accumulated Other Comprehensive Income and Changes in Members' Equity.

Cash and Cash Equivalents

For purposes of the Statement of Cash Flows, the Cooperative considers all demand deposits, money market funds, and other temporary investments with original maturities of three months or less to be cash equivalents. Cash and cash equivalents include \$1,620,640 and \$700,955 of BIP and BTOP loan and grant funds at December 31, 2011 and 2010, respectively, which are restricted for use on approved construction or equipment purchase contracts.

VALLEY TELEPHONE COOPERATIVE, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2011

Note 1 – Summary of Significant Accounting Policies: (continued)

Asset Retirement Obligations

FASC Topic 420 - Asset Retirement and Environmental Obligations requires that companies having a legal obligation to remove and dispose of assets, recognize the fair value of a liability for asset retirement obligations in the period in which the obligations are incurred and capitalize that amount as part of the book value of the long-lived asset. Although we have had no legal obligation to remove assets, depreciation rates of certain assets established by regulatory authorities have historically included a component for removal costs in excess of the related estimated salvage value. Regulatory accounting precludes us from eliminating this accumulated liability for removal costs in excess of salvage value even though there is no legal obligation to remove the assets.

Advertising

We expense advertising costs as they are incurred. These expenses, which are insignificant, include media and other promotional and sponsorship costs.

Cost Method Investments

Certain investments in securities held by us are not adjusted to market values because those values are not readily determinable and/or the securities are not marketable. However, the carrying values of these cost method securities will be adjusted if we believe that the decline in value below cost is other than temporary. The fair value of the cost method securities is not estimated if there are no identified events or changes in circumstances that may have a significant adverse effect on the fair value. The aggregate carrying amount of the cost method investments was \$164,482 and \$132,084 at December 31, 2011 and 2010, respectively.

Fair Value Measurements

In accordance with FASC Topic 820 – Fair Value Measurements and Disclosures, we measure fair value at the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants in the market in which the reporting entity transacts. We apply a hierarchy that prioritizes the information used to develop assumptions used in determining fair value. The hierarchy contains three levels of inputs: Level 1 – quoted prices in active markets for identical assets or liabilities; Level 2 – observable inputs, such as, quoted market prices of similar assets or liabilities in active markets or for identical assets or liabilities in markets that are not active; and Level 3 – unobservable inputs obtained from our own data. FASC Topic 820 applies whenever other standards require or permit assets or liabilities to be measured at fair value; however, it does not expand the use of fair value in any new circumstances. FASC Topic 820 does not apply to lower of cost or market determinations for inventory and does not eliminate the practicability exceptions to fair value measurements.

Our significant fair value measurements are those required by FASC Topic 825 - Financial Instruments and FASC Topic 360 – Property, Plant, and Equipment. We have not chosen to use fair value measurements unless required to do so by applicable accounting standards.

Note 2 – Accrued Unbilled Revenue:

These amounts include our portion of revenue for toll calls made by customers but not included in the December billing and estimated settlements revenue based on expenses incurred but not reported to the interstate pool at December 31.

VALLEY TELEPHONE COOPERATIVE, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2011

Note 3 – Property, Plant, and Equipment:

Net property, plant, and equipment at December 31, 2011 and 2010 was composed of the following:

| | <u>Depreciation Rate (%)</u> | <u>2011</u> | <u>2010</u> |
|--|----------------------------------|------------------------------|-----------------------------|
| VTCl and VTXt Telecommunications Plant in Service: | | | |
| General support | 4.1 – 33.3 | \$ 21,608,336 | \$ 21,187,352 |
| Central office | 7.5 – 19.1 | 20,327,119 | 16,452,690 |
| Information origination/termination | 15.5 | 1,106,414 | 1,198,041 |
| Cable and wire facilities | 2.2 – 6.8 | <u>103,662,685</u> | <u>93,525,231</u> |
| Total VTCl and VTXt Telecommunications Plant in Service | | 146,704,554 | 132,363,314 |
| Accumulated depreciation | | <u>(84,132,681)</u> | <u>(80,407,993)</u> |
| | | <u>62,571,873</u> | <u>51,955,321</u> |
| VTXC Plant in Service: | | | |
| General support | 3.33 – 33.3 | 6,833,485 | 5,772,773 |
| Central office | 7.5 – 14.8 | 3,499,877 | 12,188,127 |
| Cable and wire facilities | 2.0 – 6.8 | 1,307,024 | 7,398,921 |
| Internet and other equipment | 20.0 – 33.3 | <u>6,501,685</u> | <u>5,845,971</u> |
| Total VTXC Plant in Service | | 18,142,071 | 31,205,792 |
| Accumulated depreciation | | <u>(9,172,241)</u> | <u>(14,605,128)</u> |
| | | <u>8,969,830</u> | <u>16,600,664</u> |
| Telecommunications Plant Under Construction | | <u>41,882,777</u> | <u>12,876,478</u> |
| Net Property, Plant, and Equipment | | \$ <u>113,424,480</u> | \$ <u>81,432,463</u> |

All of the VTCl and VTXt telecommunications plant is pledged as security for the long-term debt to RUS.

The VTXC outside plant and circuit equipment are primarily used to provide transport services to third parties under the terms of operating agreements. VTXC also leases out floor space in its buildings.

Due to excessive competition and other factors, our transport service business segment has not achieved a level of profitability sufficient to support the value of its assets. In 2011, we concluded that the book value of its transport assets (cable and electronics) significantly exceeded the estimated future cash flows produced by these assets and that an impairment had occurred. Therefore, the Cooperative has recognized, and reported as write-down of assets, a \$7,315,297 non-cash impairment loss and the related income tax effect of \$2,487,201. The fair market value of these assets was determined from recent sales of similar assets that were used in a similar manner.

Note 4 – Investment in Cellular Entities:

We own interests in six entities operated by Cingular Wireless, LLC (Cingular). The entity names and our ownership percentages are as follows:

| | |
|---|-------|
| McAllen/Edinberg/Mission SMSA Limited Partnership | 22.5% |
| McAllen/Edinberg/Mission SMSA Tower Holdings, LLC | 22.5% |
| Texas RSA #18 Limited Partnership | 22.0% |
| Texas RSA #18 Tower Holdings, LLC | 22.0% |
| Texas RSA #19 Limited Partnership | 33.3% |
| Texas RSA #19 Tower Holdings, LLC | 33.3% |

VALLEY TELEPHONE COOPERATIVE, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2011

Note 4 – Investment in Cellular Entities: (continued)

Summarized aggregate financial information for the partnerships:

| | <u>2011</u> | <u>2010</u> |
|--------------------|-----------------------|-----------------------|
| Assets | \$ 110,911,000 | \$ 111,032,000 |
| Liabilities | \$ 49,247,000 | \$ 51,990,000 |
| Net Income | \$ 51,321,000 | \$ 52,943,000 |

The Tower Holdings, LLCs lease cellular tower sites. These lease agreements are for terms ranging from 25 - 30 years and call for prepayment of the entire contract amount. Tower Holdings records revenue related to these prepayments on a straight-line basis over the term of the contract. Tower Holdings distributed the cash received from these lease contracts to its partners creating deficit capital balances. Under the agreements, members are liable for the deficit capital balances. As such, we recorded the deficit capital as a liability, which is reflected in deferred credits and other long-term liabilities on the balance sheet.

The amount at which the partnership investments are carried on our books exceeds our ownership percentage in the underlying net assets of the partnerships by \$1,876,974. This difference is the result of assets contributed by the general partner after the merger between AT&T Mobility and AT&T Wireless Services, Inc. The assets were recorded at the carryover basis which was less than their fair market value but our cash contribution required to match the asset contribution was based on fair value of the assets.

Note 5 – Intangibles:

| | <u>2011</u> | <u>2010</u> |
|--------------------------------------|--------------------------|--------------------------|
| Indefinite Lived Intangibles: | | |
| FCC license | \$ 411,632 | \$ 411,632 |
| Fiber optic right-of-way | 68,750 | 275,000 |
| Other | <u>5,602</u> | <u>5,602</u> |
| Total Intangibles | <u>\$ 485,984</u> | <u>\$ 692,234</u> |

The fiber optic right-of-way was one of the assets impaired as discussed on page 16. An impairment loss of \$206,250 was recognized on this asset and is included in the total impairment amount per page 16.

Note 6 – Long-Term Debt:

The Cooperative is indebted to the United States of America – RUS as follows:

| | <u>2011</u> | <u>2010</u> |
|---|--------------------|---------------------|
| RUS Mortgage Notes | | |
| 2% due in quarterly installments through 2014 | \$ 859,764 | \$ 1,367,251 |
| 4.06% to 5% due in monthly installments through 2029 | 11,178,636 | 12,039,380 |
| RUS BIP Note | | |
| 2.51% to 4.5%, due in monthly installments through 2031 | 15,024,910 | 1,918,319 |

VALLEY TELEPHONE COOPERATIVE, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2011

Note 6 – Long-Term Debt: (continued)

| | <u>2011</u> | <u>2010</u> |
|---------------------------|----------------------|----------------------|
| Capital lease obligations | <u>55,720</u> | <u>81,296</u> |
| Total Principal | 27,119,030 | 15,406,246 |
| Less: Current maturities | <u>1,891,190</u> | <u>1,418,519</u> |
| Total Long-Term Debt | <u>\$ 25,227,840</u> | <u>\$ 13,987,727</u> |

In 2010, VTCI and VTXT received a joint award from the RUS through BIP which consists of \$40,093,153 of loan funds and \$38,520,868 of available grant money. The intent is for all of the funds to be used by and loan funds repaid by VTXT. Funds are disbursed to us pro-rata based on the total loan/grant amount. Both entities are jointly and severally liable for the debt and the assets of both entities are pledged as security on the debt. At December 31, 2011, we had \$23,397,721 of unadvanced loan funds available.

The above RUS notes are secured by a mortgage on substantially all of the telephone plant. Payments on 2 percent notes are due quarterly in the approximate amount of \$130,000 and payments on 4.06 to 5 percent notes are due monthly in the approximate amount of \$122,000. Payments on the RUS BIP note are currently \$91,000 per month. The capital lease payments are \$2,441 per month. The maturities of long-term debt for each of the five years succeeding the balance sheet date are as follows:

| | |
|------|--------------|
| 2012 | \$ 1,891,190 |
| 2013 | 1,828,025 |
| 2014 | 1,568,096 |
| 2015 | 1,353,815 |
| 2016 | 1,413,141 |

The RUS and RTB long-term debt agreements contain restrictions on the payment of patronage dividends. The restrictions are related in general to our adjusted net worth and assets as defined in said agreements and the restrictions on investment in affiliates.

The Cooperative has an \$8,000,000 revolving line-of-credit commitment with CoBank that commenced August 3, 2011 and expires August 3, 2014. It bears interest at the variable LIBOR rate currently 3.3 percent. The line-of-credit is secured by all of the assets of VTXC, except those acquired by BTOP funds, and is guaranteed by VTXI. There were no amounts outstanding under the line-of-credit at December 31, 2011.

Note 7 – Income Taxes:

Deferred tax assets and liabilities result primarily from differences in the bases of partnership investments and depreciation methods and lives used for financial and income tax reporting. The net deferred tax liability includes the following components:

| | <u>2011</u> | <u>2010</u> |
|------------------------------|---------------------|---------------------|
| Deferred tax liabilities | \$ 7,861,156 | \$ 8,037,562 |
| Deferred tax assets | <u>(1,306,146)</u> | <u>(1,446,500)</u> |
| Net Deferred Tax Liabilities | <u>\$ 6,555,010</u> | <u>\$ 6,591,062</u> |

VALLEY TELEPHONE COOPERATIVE, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2011

Note 7 – Income Taxes: (continued)

Components of income tax expense:

| | <u>2011</u> | <u>2010</u> |
|-----------------------|----------------------------|----------------------------|
| Nonoperating current | \$ 4,385,149 | \$ 3,937,284 |
| Nonoperating deferred | 260,642 | 671,698 |
| Operating current | (2,422,200) | (1,258,841) |
| Operating deferred | <u>(1,090,748)</u> | <u>171,066</u> |
| Total | <u>\$ 1,132,843</u> | <u>\$ 3,521,207</u> |

The provision for income tax differs from the amount calculated using income before taxes at the statutory rate because of permanent differences, changes in prior year tax estimates and VTCI's patronage exclusion.

We have not identified any uncertain tax positions requiring recognition in our financial statements and we believe that the positions taken would not require settlement at an amount less than full recognition. VTCI or one of its subsidiaries files income tax returns in the U.S. federal jurisdiction and the State of Texas. We are generally no longer subject to U.S. federal income tax examinations by tax authorities for years before 2008 and we are no longer subject to examination by the State of Texas for years before 2007.

Note 8 – Employee Benefits:

We have a defined benefit pension plan in effect for all employees, which is part of the retirement and security program with the National Telephone Cooperative Association (NTCA). It is a multi-employer plan which constitutes a "master plan" for purposes of Revenue Procedures 84-23, 1984-1 C.B. 457. It covers many full-time employees of NTCA, its affiliates, and its member organizations who have adopted the plan.

This plan is funded through employer contributions of 9.3 percent of salary plus rule of 85 charges. We also paid a 2 percent of salary surcharge in 2011 and 2010 to compensate for prior underperformance of the fund. These contributions, plus earnings that accumulate tax deferred in the program's unallocated trust fund, are sufficient to fund the plan's past and future service costs on an ongoing basis. Information necessary for other disclosures required by FASC Topic 715 are not available on a company by company basis because all pension fund assets and vested benefits are pooled for investment and reporting purposes. Our cost under this plan for 2011 and 2010 was \$1,016,772 and \$862,981, respectively.

We have a savings plan in effect covering substantially all of our employees meeting the length of service and minimum hour requirements. We contribute 1 percent of an employee's annual salary to the plan and the employee can contribute between 1 percent and 20 percent of annual salary. Our cost for the plan was \$50,553 and \$58,871 for 2011 and 2010, respectively.

We have a defined benefit postretirement health plan that covers both salaried and hourly employees and directors and retirees who retire pursuant to our eligibility requirements. These benefits are provided through the NTCA health insurance program. We record the obligation for future retirees' health care benefits in accordance with FASC Topic 715. We fund these postretirement benefits using NTCA trust accounts. The following sets forth information for the other postretirement benefits at and for the years ended December 31:

VALLEY TELEPHONE COOPERATIVE, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2011

Note 8 – Employee Benefits: (continued)

| <u>Obligations and Funded Status</u> | <u>2011</u> | <u>2010</u> |
|---|-----------------------|-----------------------|
| Benefit obligation measured at December 31 | \$ 13,318,138 | \$ 11,468,358 |
| Fair value of plan assets measured at December 31 | <u>5,407,418</u> | <u>4,636,874</u> |
| Unfunded status – liability recognized in the balance sheet | <u>\$ (7,910,720)</u> | <u>\$ (6,831,484)</u> |
| | <u>2011</u> | <u>2010</u> |
| Net periodic benefit cost | \$ 1,251,820 | \$ 1,039,378 |
| Employer contributions | 796,284 | 149,176 |
| Participant contributions | 78,031 | 75,387 |
| Benefits paid | 296,284 | 149,176 |

Assumptions

| | | |
|--|--------------------|--------------------|
| Weighted average assumptions used to determine the benefit obligation and net periodic benefit cost: | <u>2011</u> | <u>2010</u> |
| Discount rate | 5.5% | 5.75% |
| Expected return on plan assets | 7.47% | 8.30% |
| Rate of compensation increase | 3.0% | 6.0% |

Our expected return on plan assets is determined by the plan assets' long-term investment performance, current asset allocation and estimates of future long-term returns by asset class.

The health care cost trend rate used to measure the expected cost of benefits was a 9 percent annual rate of increase in 2011 declining to 7 percent in 2012 and gradually continuing to decline to 5 percent by the year 2015.

Plan Assets

We contribute to a regional NTCA VEBA trust and the NTCA 401(h) Prefunding Account to fund our postretirement benefit liability. The trustees of these accounts work with an investment firm to set the investment policy. All of the trust account investments are in managed funds. The investment firm coordinates the multiple fund managers. The investment policy for plan assets is to manage the portfolio to preserve principal and liquidity while maximizing the return on the investment portfolio through the full investment of available funds. The portfolio is diversified by investing in multiple types of investment-grade securities. The target allocations for plan assets 401(h) account are 23 percent domestic equity securities, 32 percent international equities, 10 percent private equities, 25 percent fixed income and 10 percent real estate. The target allocations for the VEBA are 27 percent domestic equity securities, 38 percent international equities, 15 percent investment grade bonds, 10 percent high yield bonds and 10 percent real estate.

The fair value of our plan assets held in the NTCA trusts is allocated semi-annually to each participating member. The assets are allocated in total and not by type of investment. The amounts below represent our pro-rata share of each type of investment based on our allocated trust value at December 31 as a percentage of the total trust value.

VALLEY TELEPHONE COOPERATIVE, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2011

Note 8—Employee Benefits: (continued)

| | <u>2011</u> | <u>2010</u> |
|--------------------|----------------------------|----------------------------|
| Equity securities: | | |
| Domestic | \$ 1,534,274 | \$ 1,351,487 |
| International | 1,516,468 | 1,096,563 |
| Corporate bonds | 1,250,602 | 1,038,349 |
| Government bonds | 216,743 | 271,610 |
| Real Estate | 598,792 | 538,839 |
| Private Equity | 192,028 | 240,638 |
| Cash | <u>98,511</u> | <u>99,388</u> |
| Total | <u>\$ 5,407,418</u> | <u>\$ 4,636,874</u> |

All of the fair values were determined using Level 1 inputs.

Cash Flows

We expect to contribute \$817,000 to our other postretirement benefit plan in 2012 which is our estimate of 2012 out-of-pocket benefit payments.

The following benefit payments, which reflect expected future service, as appropriate, are expected to be paid:

| | |
|-----------|------------|
| 2012 | \$ 317,024 |
| 2013 | 336,045 |
| 2014 | 354,528 |
| 2015 | 372,254 |
| 2016 | 390,867 |
| 2017–2021 | 2,267,776 |

Accumulated Other Comprehensive Income (AOCI):

Amounts in AOCI that have not been recognized in net periodic cost:

| | <u>2011</u> | <u>2010</u> |
|--------------------|----------------------------|----------------------------|
| Net loss | \$ 3,955,239 | \$ 3,336,405 |
| Prior service cost | 194,857 | 268,023 |
| Income tax effect | <u>-0-</u> | <u>(163,366)</u> |
| | <u>\$ 4,150,096</u> | <u>\$ 3,441,062</u> |

Amounts recognized in comprehensive income (pre-tax):

| | <u>2011</u> | <u>2010</u> |
|-------------------------------------|----------------------------|----------------------------|
| Net loss arising during the year | \$ (731,634) | \$ (322,112) |
| Amortization of net loss | 112,799 | 116,711 |
| Amortization of prior service costs | <u>73,166</u> | <u>73,166</u> |
| | <u>\$ (545,669)</u> | <u>\$ (132,235)</u> |

VALLEY TELEPHONE COOPERATIVE, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2011

Note 8 – Employee Benefits: (continued)

Amounts in AOCI expected to be recognized in net periodic cost in fiscal year 2012:

| | |
|-------------------------------------|-------------------|
| Amortization of net loss | \$ 137,710 |
| Amortization of prior service costs | <u>73,166</u> |
| | <u>\$ 210,876</u> |

Other Information

On December 8, 2003, the Medicare Prescription Drug, Improvement and Modernization Act of 2003 (the Act) was signed into law. The Act introduces a prescription drug benefit under Medicare (Medicare Part D) as well as a federal subsidy to sponsors of retiree health care benefit plans that provide a benefit that is at least actuarially equivalent to Medicare Part D. We are impacted by the Act since we sponsor a postretirement health care plan that provides prescription drug benefits. Although we have determined that the benefit we provide is at least actuarially equivalent to Medicare Part D, measures of the APBO and net periodic benefit cost do not reflect any amount associated with the subsidy because we have chosen not to file for the subsidy at this time. This decision was made based on a comparison of cost associated with filing for the subsidy versus the benefit provided.

Note 9 – Leases:

We lease certain facilities and equipment for use in our operations under both capital and operating leases. Total rent expense under operating leases amounted to \$615,659 in 2011 and \$577,256 in 2010.

Capital lease amounts included in property, plant, and equipment are as follows:

| At December 31, | <u>2011</u> | <u>2010</u> |
|--------------------------|------------------|-------------------|
| Capital leases | \$ 129,368 | \$ 129,368 |
| Accumulated amortization | <u>(35,576)</u> | <u>(21,246)</u> |
| Total | <u>\$ 93,792</u> | <u>\$ 108,122</u> |

The aggregate minimum rental commitments under noncancelable leases for the periods shown at December 31, 2011 are as follows:

| Years: | <u>Capital Leases</u> | <u>Operating Leases</u> |
|---|---------------------------|-----------------------------|
| 2012 | \$ 29,294 | \$ 266,376 |
| 2013 | 29,294 | 261,325 |
| 2014 | 549 | 236,706 |
| 2015 | -0- | 85,987 |
| 2016 | -0- | 14,433 |
| Thereafter | -0- | -0- |
| Total minimum rental commitments | <u>59,137</u> | <u>\$ 864,827</u> |
| Less interest and executory costs | <u>(3,417)</u> | |
| Present value of minimum lease payments | <u>55,720</u> | |
| Less current installments | <u>(26,903)</u> | |
| Long-term obligation at December 31, 2011 | <u>\$ 28,817</u> | |

Amortization of assets under capital lease is included in depreciation expense.

VALLEY TELEPHONE COOPERATIVE, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2011

Note 10 – Additional Cash Flow Information:

| Cash paid during the year: | <u>2011</u> | <u>2010</u> |
|--|--------------------|--------------------|
| Interest (net of capitalized interest) | \$ 234,967 | \$ 362,849 |
| Income taxes | \$ 1,032,377 | \$ 3,867,855 |

Note 11 – Concentrations of Credit Risk:

Financial instruments that subject us to concentrations of credit risk consist primarily of temporary cash investments, marketable securities and trade receivables. Our policy is to place temporary cash investments with major federally insured financial institutions, to limit the amount of credit exposure to any one financial institution and to monitor counter parties' credit ratings. We require cash deposits from customers that do not have a sufficient credit rating but that is our only collateral requirement. Management believes the risk of credit loss due to nonperformance by counter parties is unlikely and any losses would not be material to the results of operations or financial condition.

At December 31, 2011, we have \$7,542,000 of uninsured deposits. We have \$3,253,000 in Bank of America (BOA) checking accounts and \$495,000 in BOA Fidelity money market accounts, \$752,000 of which is covered by FDIC insurance. The underlying investments for the money market accounts are AAA rated short-term U.S. government treasury and agency notes.

Concentrations of credit risk with respect to telecommunications accounts receivable are limited due to the large number of customers. Management believes the risk of nonpayment of other accounts receivable to be low based on the nature of the receivables.

We received 62 percent and 61 percent of our gross revenue from three sources in 2011 and 2010, respectively.

Note 12 – Fair Value Measurements and Financial Instruments:

The following are the major categories of assets and liabilities measured at fair value on a recurring basis during the year ended December 31.

| ASSETS | Level 1: | Level 2: | Level 3: | Total at |
|----------------------------|--------------------------------|---------------------------|----------------------------|---------------------------|
| <u>Description</u> | <u>Quoted Prices in</u> | <u>Significant</u> | <u>Significant</u> | <u>December 31</u> |
| | <u>Active Markets</u> | <u>Other</u> | <u>Unobservable</u> | |
| | <u>for Identical</u> | <u>Observable</u> | <u>Inputs</u> | |
| | <u>Assets</u> | <u>Inputs</u> | | |
| None | | | | |
| LIABILITIES | | | | |
| <u>Description</u> | | | | |
| Long-term debt, 12/31/2010 | \$ -0- | \$ 15,334,000 | \$ -0- | \$ 15,334,000 |
| Long-term debt, 12/31/2011 | \$ -0- | \$ 25,414,000 | \$ -0- | \$ 25,414,000 |

VALLEY TELEPHONE COOPERATIVE, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2011

Note 12 – Fair Value Measurements and Financial Instruments: (continued)

The fair value of our debt is calculated as the present value of remaining payments discounted at a market interest rate of five percent. The fair value of debt is not recognized in the balance sheet but is for FASC Topic 825 disclosure purposes only. The estimated fair value of our debt at December 31, 2011 and 2010 was \$25,414,000 and \$15,334,000, respectively, which differs from the carrying amounts of \$27,119,030 and \$15,406,246, respectively, included in the consolidated balance sheets.

Our financial instruments include cash and short-term and long-term investments, receivables, payables and debt. Except as described below, the estimated fair value of such financial instruments at December 31, 2011 and 2010 approximate their carrying value as reflected in the consolidated balance sheets.

The following are the major categories of assets and liabilities measured at fair value on a non-recurring basis during the year ended December 31.

| ASSETS | Level 1: Quoted Prices in Active Markets for Identical Assets | Level 2: Significant Other Observable Inputs | Level 3: Significant Unobservable Inputs | Total at December 31 |
|--|--|---|---|---------------------------------|
| <u>Description</u> | | | | |
| Cable and electronic equipment, 12/31/2010 | | \$ -0- | | \$ -0- |
| Cable and electronic equipment, 12/31/2011 | | \$ 2,397,586 | | \$ 2,397,586 |

LIABILITIES

Description

None

Cable and electronic equipment used in our transport business was written down to its fair value of \$2,397,586, resulting in an impairment charge of \$7,315,297 which was included in operating expense. Fair value was determined based on sales of similar assets.

Note 14 – Subsequent Events:

We have evaluated subsequent events through March 20, 2012, the date which the financial statements were available to be issued.

SUPPLEMENTARY INFORMATION

VALLEY TELEPHONE COOPERATIVE, INC.
CONSOLIDATING BALANCE SHEETS
DECEMBER 31

| | VTXI | | VTXC Consolidated with VTXI | | VTXT | | Eliminations | | Consolidated | |
|---|-----------------------|-----------------------|--------------------------------|----------------------|----------------------|----------------------|------------------------|------------------------|-----------------------|-----------------------|
| | 2011 | 2010 | 2011 | 2010 | 2011 | 2010 | 2011 | 2010 | 2011 | 2010 |
| Current Assets: | | | | | | | | | | |
| Cash and cash equivalents | \$ 1,298,706 | \$ 1,434,484 | \$ 6,712,233 | \$ 4,123,787 | \$ 1,698,026 | \$ 1,133,876 | | | \$ 8,706,864 | \$ 6,692,147 |
| Telecommunications accounts receivable | 386,706 | 369,628 | 92,265 | 143,807 | 51,213 | 53,219 | | | 530,183 | 566,654 |
| Other accounts receivable | 2,869,806 | 1,951,716 | 177,785 | 309,177 | 60,374 | 59,103 | | | 3,107,865 | 2,319,996 |
| Accrued unbilled revenue | -0- | 40,000 | 31,024 | 31,024 | | | | | 31,024 | 71,024 |
| Materials and supplies | 5,048,551 | 5,814,911 | 403,517 | 533,080 | 105,684 | 53,884 | | | 5,557,652 | 6,401,875 |
| Deferred income tax | | | 239,998 | 194,968 | | | | | 239,998 | 194,968 |
| Prepayments | 904,829 | 1,221,149 | 100,573 | 108,358 | 8,374 | 3,934 | | | 1,013,776 | 1,333,441 |
| Total Current Assets | 10,508,597 | 10,831,868 | 6,757,395 | 5,444,201 | 1,921,570 | 1,304,016 | | | 19,187,562 | 17,580,105 |
| Property, Plant, and Equipment: | | | | | | | | | | |
| Plant in service | 137,080,810 | 125,100,960 | 18,142,071 | 31,205,791 | 9,623,744 | 7,262,354 | | | 164,846,625 | 163,569,105 |
| Plant under construction | 4,302,589 | 9,125,777 | 4,841,624 | 688,818 | 32,738,564 | 3,061,883 | | | 41,882,777 | 12,876,478 |
| Total Property, Plant, and Equipment | 141,383,399 | 134,226,737 | 22,983,695 | 31,894,609 | 42,362,308 | 10,324,237 | | | 206,729,402 | 176,445,583 |
| Less: Accumulated depreciation | 82,618,479 | 79,445,679 | 9,172,241 | 14,605,127 | 1,614,202 | 962,114 | | | 93,304,922 | 95,013,120 |
| Net Property, Plant, and Equipment | 58,764,920 | 54,780,858 | 13,811,454 | 17,289,482 | 40,748,106 | 9,362,123 | | | 113,424,480 | 81,432,463 |
| Investments and Other Assets: | | | | | | | | | | |
| Investment in cellular entities | | | 22,556,668 | 21,838,669 | | | | | 22,556,668 | 21,838,669 |
| Investment in affiliates | 48,485,951 | 47,082,510 | | | | | \$ (48,485,951) | \$ (47,082,510) | -0- | -0- |
| Advances to affiliates | | | 18,880,400 | 12,653,175 | | | (18,880,400) | (12,653,175) | -0- | -0- |
| Other assets | 182,185 | 339,104 | 139,028 | 128,982 | | | | | 321,213 | 468,066 |
| Intangibles | | | 485,984 | 692,234 | | | | | 485,984 | 692,234 |
| Total Noncurrent Assets | 48,668,136 | 47,421,614 | 42,082,080 | 35,313,060 | -0- | -0- | (67,348,351) | (59,735,685) | 23,363,866 | 22,998,969 |
| Total Assets | \$ 117,921,653 | \$ 113,034,360 | \$ 62,630,929 | \$ 58,046,743 | \$ 42,769,676 | \$ 10,666,139 | \$ (67,348,351) | \$ (59,735,685) | \$ 165,975,907 | \$ 122,011,557 |

SUPPLEMENTARY INFORMATION - See Independent Auditor's Report.

VALLEY TELEPHONE COOPERATIVE, INC.
CONSOLIDATING BALANCE SHEETS
DECEMBER 31

| | VTCI | | VTXC Consolidated with VTXI | | VTXT | | Eliminations | | Consolidated | |
|--|-----------------------|-----------------------|--------------------------------|----------------------|----------------------|----------------------|------------------------|------------------------|-----------------------|-----------------------|
| | 2011 | 2010 | 2011 | 2010 | 2011 | 2010 | 2011 | 2010 | 2011 | 2010 |
| Current Liabilities: | | | | | | | | | | |
| Current maturities long-term debt | \$ 1,319,104 | \$ 1,415,032 | | | \$ 572,086 | \$ 3,487 | | | \$ 1,891,190 | \$ 1,418,519 |
| Accounts payable | 1,395,171 | 2,001,828 | \$ 3,658,733 | \$ 272,767 | 4,679,346 | 181,333 | | | 8,733,250 | 2,455,928 |
| Advance billing | 138,762 | 334,505 | 361,588 | 415,386 | 20,726 | 12,106 | | | 521,066 | 761,997 |
| Patronage capital credits payable | 682,381 | 848,751 | | | | | | | 682,381 | 848,751 |
| Accrued income taxes | | | 62,464 | 42,638 | -0- | 4,087 | | | 62,464 | 46,725 |
| Other accrued liabilities | 911,780 | 544,701 | 136,184 | 211,736 | 23,902 | 1,212 | | | 1,071,866 | 757,649 |
| Customer deposits | 23,663 | 27,433 | | | | | | | 23,663 | 27,433 |
| Total Current Liabilities | 4,470,851 | 5,172,250 | 4,218,959 | 942,527 | 5,296,060 | 202,225 | | | 13,985,870 | 6,317,002 |
| Long-Term Debt, Less Current Maturities: | | | | | | | | | | |
| RUS notes | 10,746,189 | 12,017,193 | | | 14,462,824 | 1,914,832 | | | 25,199,023 | 13,932,025 |
| Capital leases | 28,817 | 55,702 | | | -0- | -0- | | | 28,817 | 55,702 |
| Total Long-Term Debt, Less Current Maturities | 10,775,016 | 12,072,895 | -0- | -0- | 14,462,824 | 1,914,832 | | | 25,227,840 | 13,987,727 |
| Other Liabilities: | | | | | | | | | | |
| Deferred revenue | | | 3,288,950 | 2,645,306 | 14,622,707 | 1,820,271 | | | 17,811,657 | 4,465,577 |
| Deferred income taxes | | | 5,684,199 | 6,161,975 | 1,110,809 | 624,055 | | | 6,795,008 | 6,786,030 |
| Share of deficiency of assets of LLCs | | | 5,235,276 | 5,542,919 | | | | | 5,235,276 | 5,542,919 |
| Advances from affiliates | 16,765,529 | 11,470,461 | | | 3,124,871 | 1,182,714 | \$ (18,880,400) | \$ (12,653,175) | -0- | -0- |
| Accrued postretirement benefits | 7,910,720 | 5,920,815 | -0- | 910,669 | | | | | 7,910,720 | 6,831,484 |
| Total Other Liabilities | 23,666,249 | 17,391,276 | 14,208,424 | 15,260,869 | 18,758,387 | 3,627,040 | (18,880,400) | (12,653,175) | 37,752,660 | 23,626,010 |
| Equity: | | | | | | | | | | |
| Retained margin | 57,850,020 | 57,719,112 | | | | | | | 57,850,020 | 57,719,112 |
| Patronage capital assigned | 22,413,618 | 22,014,462 | | | | | | | 22,413,618 | 22,014,462 |
| Patronage capital assignable | 2,895,995 | 1,788,306 | | | | | | | 2,895,995 | 1,788,306 |
| Accumulated other comprehensive income: | | | | | | | | | | |
| Unrecognized postretirement benefit costs | (4,150,096) | (3,123,941) | -0- | (317,121) | | | | | (4,150,096) | (3,441,062) |
| Members' equity | | | 44,203,546 | 42,160,468 | 4,262,405 | 4,922,042 | (48,465,951) | (47,082,510) | -0- | -0- |
| Total Equity | 79,009,537 | 78,397,939 | 44,203,546 | 41,843,347 | 4,262,405 | 4,922,042 | (48,465,951) | (47,082,510) | 79,009,537 | 78,080,818 |
| Total Liabilities and Equity | \$ 117,921,653 | \$ 113,034,360 | \$ 62,630,929 | \$ 58,046,743 | \$ 42,769,676 | \$ 10,666,139 | \$ (67,346,351) | \$ (59,735,685) | \$ 165,975,907 | \$ 122,011,557 |

SUPPLEMENTARY INFORMATION - See Independent Auditor's Report.

VALLEY TELEPHONE COOPERATIVE, INC.
CONSOLIDATING STATEMENTS OF OPERATIONS
DECEMBER 31

| | VTCL | | VTXC Consolidated with VTCL | | VTXT | | Eliminations | | Consolidated | |
|---------------------------------------|---------------------|---------------------|--------------------------------|---------------------|---------------------|---------------------|-----------------------|-----------------------|---------------------|---------------------|
| | 2011 | 2010 | 2011 | 2010 | 2011 | 2010 | 2011 | 2010 | 2011 | 2010 |
| Operating Revenues: | | | | | | | | | | |
| Local network services | \$ 1,246,837 | \$ 1,198,119 | | | \$ 113,273 | \$ 101,856 | | | \$ 1,360,110 | \$ 1,299,975 |
| Network access services | 20,407,487 | 18,333,873 | | | 506,068 | 496,972 | \$ (327,222) | \$ (265,245) | 20,586,333 | 18,565,600 |
| Long distance network services | 64,625 | 82,102 | \$ 695,301 | \$ 741,378 | 7,667 | 6,701 | | | 767,493 | 830,181 |
| Internet and video services | | | 4,492,210 | 3,863,299 | 333,082 | 99,577 | (231,039) | (36,000) | 4,584,263 | 3,926,876 |
| Transport services | | | 3,940,407 | 3,784,306 | | | (224,073) | (210,125) | 3,716,334 | 3,574,181 |
| Grant revenue | | | | | 5,975 | -0- | | | 5,975 | -0- |
| Miscellaneous | 360,203 | 395,733 | 224,082 | 223,769 | 56,415 | 51,655 | (107,060) | (110,885) | 533,660 | 560,272 |
| Less: Uncollectible revenues | 28,977 | (10,422) | (141,238) | (97,300) | (32,592) | (28,729) | | | (144,853) | (136,451) |
| Total Operating Revenues | 22,108,129 | 19,999,405 | 9,210,772 | 8,615,452 | 989,788 | 728,032 | (889,394) | (622,255) | 31,419,296 | 28,620,634 |
| Operating Expenses: | | | | | | | | | | |
| Plant specific operations | 4,713,404 | 4,880,790 | 2,399,531 | 2,301,575 | 225,997 | 130,416 | (62,760) | (62,760) | 7,276,172 | 7,250,021 |
| Plant nonspecific operations | 2,791,071 | 2,062,815 | 3,674,537 | 3,695,225 | 807,904 | 365,402 | (746,334) | (475,370) | 6,527,178 | 5,848,072 |
| Depreciation and amortization | 5,273,948 | 4,567,829 | 3,264,621 | 2,821,168 | 582,088 | 431,626 | | | 9,090,657 | 7,820,623 |
| Customer operations | 1,662,243 | 1,658,907 | 457,739 | 447,544 | 184,278 | 82,563 | (44,300) | (48,125) | 2,259,960 | 2,140,889 |
| Corporate operations | 3,971,396 | 4,232,161 | 1,822,209 | 1,711,339 | 168,873 | 182,705 | (36,000) | (36,000) | 5,926,478 | 6,090,205 |
| Write-down of assets | | | 7,316,297 | -0- | | | | | 7,316,297 | -0- |
| Total Operating Expenses | 18,412,062 | 17,402,502 | 18,933,934 | 10,976,851 | 1,939,140 | 1,192,712 | (889,394) | (622,255) | 38,396,742 | 28,949,810 |
| Operating Taxes | | | | | | | | | | |
| Income taxes | | | (3,177,702) | (922,099) | (336,246) | (165,676) | | | (3,512,948) | (1,087,775) |
| Other operating taxes | 467,266 | 454,061 | 384,371 | 384,452 | 43,928 | 16,208 | | | 895,565 | 854,721 |
| Total Operating Taxes | 467,266 | 454,061 | (2,793,331) | (537,647) | (291,318) | (149,468) | -0- | -0- | (2,617,383) | (233,054) |
| Operating Margin | 3,228,801 | 2,142,842 | (6,929,831) | (1,923,752) | (658,034) | (315,212) | -0- | -0- | (4,359,064) | (96,122) |
| Nonoperating Margin: | | | | | | | | | | |
| Interest and investment income | 2,003 | 550 | 629 | 3,862 | | | | | 2,632 | 4,412 |
| Share of cellular entities income | | | 13,540,926 | 13,608,234 | | | | | 13,540,926 | 13,608,234 |
| Other nonoperating income (expense) | (54,709) | -0- | 32,011 | 34,439 | (1,600) | -0- | | | (24,298) | 34,439 |
| Income tax benefit (expense) | (46,133) | 7,761 | (4,600,658) | (4,616,743) | | | | | (4,646,791) | (4,608,982) |
| Equity in income (loss) of affiliate | 1,383,443 | 6,784,437 | | | | | (1,383,443) | (6,784,437) | -0- | -0- |
| Total Nonoperating Margin | 1,285,604 | 6,792,748 | 8,972,908 | 9,029,792 | (1,600) | -0- | (1,383,443) | (6,784,437) | 8,873,489 | 9,038,103 |
| Margin Before Interest Charges | 4,514,405 | 8,935,590 | 2,043,077 | 7,106,040 | (659,634) | (315,212) | (1,383,443) | (6,784,437) | 4,514,405 | 8,941,981 |
| Interest Charges: | | | | | | | | | | |
| Interest on long-term debt | 600,266 | 653,579 | | | 303,933 | 6,391 | | | 904,189 | 659,970 |
| Other interest | 46,973 | 6,560 | | | | | | | 46,973 | 6,560 |
| Capitalized interest | (412,262) | (297,290) | | | (303,933) | -0- | | | (716,185) | (297,290) |
| Total Interest Charges | 234,967 | 362,849 | -0- | -0- | -0- | 6,391 | -0- | -0- | 234,967 | 369,240 |
| Net Margin | \$ 4,279,438 | \$ 8,572,741 | \$ 2,043,077 | \$ 7,106,040 | \$ (659,634) | \$ (321,603) | \$ (1,383,443) | \$ (6,784,437) | \$ 4,279,438 | \$ 8,572,741 |

SUPPLEMENTARY INFORMATION - See Independent Auditor's Report.

VALLEY TELEPHONE COOPERATIVE, INC.
CONSOLIDATING STATEMENTS OF CASH FLOWS
DECEMBER 31

| | VTCI | | VTXC Consolidated with VTXI | | VTXT | | Eliminations | | Consolidated | |
|--|---------------------|---------------------|--------------------------------|---------------------|---------------------|---------------------|------------------|------------------|---------------------|---------------------|
| | 2011 | 2010 | 2011 | 2010 | 2011 | 2010 | 2011 | 2010 | 2011 | 2010 |
| Cash Flows from Operating Activities: | | | | | | | | | | |
| Net margin | \$ 4,279,438 | \$ 8,572,741 | \$ 2,043,077 | \$ 7,106,040 | \$ (659,634) | \$ (321,603) | \$ (1,383,443) | \$ (6,784,437) | \$ 4,279,438 | \$ 8,572,741 |
| Adjustments to reconcile net margin to net cash provided by operating activities: | | | | | | | | | | |
| Depreciation and amortization | 5,273,948 | 4,567,829 | 3,284,621 | 2,821,168 | 552,088 | 431,626 | | | 9,080,657 | 7,820,623 |
| Share of cellular entities earnings | | | (13,640,926) | (13,608,234) | | | | | (13,640,926) | (13,608,234) |
| Income of affiliates | (1,383,443) | (6,784,437) | | | | | 1,383,443 | 6,784,437 | -0- | -0- |
| Distributions from cellular entities | | | 12,515,283 | 11,517,337 | | | | | 12,515,283 | 11,517,337 |
| Loss on sale and write-down of plant | | | 7,339,667 | -0- | | | | | 7,339,667 | -0- |
| Capital certificates received | | | (33,398) | (21,568) | | | | | (33,398) | (21,568) |
| Amortization of deferred grant revenue | | | | | (5,975) | -0- | | | (5,975) | -0- |
| Change in assets and liabilities: | | | | | | | | | | |
| Accounts receivable | (895,167) | 180,450 | 182,934 | 61,443 | 734 | (23,407) | | | (711,499) | 218,486 |
| Prepays | 316,320 | (1,033,536) | 7,786 | (2,418) | (4,440) | (3,085) | | | 319,666 | (1,039,039) |
| Deferred charges | 166,922 | (312,653) | (21,679) | 89,089 | | | | | 135,243 | (223,564) |
| Accounts payable and accruals | 1,227,173 | (130,289) | (682,652) | 611,580 | 48,766 | 157 | | | 593,267 | 481,448 |
| Deferred credits | | | (816,614) | 1,286,402 | 488,764 | 75,066 | | | (329,860) | 1,361,466 |
| Total Adjustments | <u>4,695,753</u> | <u>(3,512,636)</u> | <u>8,215,021</u> | <u>2,754,799</u> | <u>1,077,927</u> | <u>480,357</u> | <u>1,383,443</u> | <u>6,784,437</u> | <u>16,372,144</u> | <u>8,506,957</u> |
| Net Cash Provided by (Used In) Operating Activities | <u>8,975,191</u> | <u>5,060,105</u> | <u>10,268,098</u> | <u>9,860,839</u> | <u>418,293</u> | <u>158,754</u> | <u>-0-</u> | <u>-0-</u> | <u>19,651,582</u> | <u>15,079,698</u> |
| Cash Flows from Investing Activities: | | | | | | | | | | |
| Capital expenditures | <u>(9,194,174)</u> | <u>(13,102,548)</u> | <u>(3,424,909)</u> | <u>(4,226,419)</u> | <u>(27,613,301)</u> | <u>(3,888,656)</u> | <u>-0-</u> | <u>-0-</u> | <u>(40,232,384)</u> | <u>(21,217,623)</u> |
| Cash Flows from Financing Activities: | | | | | | | | | | |
| Payments of long-term debt | (1,393,807) | (1,771,053) | | | (98,237) | -0- | | | (1,482,044) | (1,771,053) |
| RUS loan advances | | | 982,481 | 290,362 | 12,708,410 | 1,820,271 | | | 13,690,891 | 2,110,653 |
| Grant proceeds | | | | | 13,204,828 | 1,918,319 | | | 13,204,828 | 1,918,319 |
| Proceeds from line-of-credit | | | 750,000 | -0- | | | | | 750,000 | -0- |
| Payments on line-of-credit | | | (750,000) | -0- | | | | | (750,000) | -0- |
| Capital credits paid | (2,811,303) | (2,373,191) | | | | | | | (2,811,303) | (2,373,191) |
| Excise tax refund received | 3,247 | 3,559 | | | | | | | 3,247 | 3,559 |
| Advances from (to) affiliate | <u>4,285,068</u> | <u>12,383,321</u> | <u>(6,227,224)</u> | <u>(13,423,749)</u> | <u>1,942,166</u> | <u>1,040,428</u> | <u>-0-</u> | <u>-0-</u> | <u>-0-</u> | <u>-0-</u> |
| Net Cash Provided by (Used In) Financing Activities | <u>83,205</u> | <u>8,242,636</u> | <u>(5,244,743)</u> | <u>(13,133,367)</u> | <u>27,757,167</u> | <u>4,779,018</u> | <u>-0-</u> | <u>-0-</u> | <u>22,595,619</u> | <u>(111,713)</u> |
| Net (Decrease) Increase in Cash and Cash Equivalents | <u>(136,778)</u> | <u>200,193</u> | <u>1,588,446</u> | <u>(7,498,947)</u> | <u>562,149</u> | <u>1,049,116</u> | <u>-0-</u> | <u>-0-</u> | <u>2,014,817</u> | <u>(6,249,636)</u> |
| Cash and Cash Equivalents at Beginning of Year | <u>1,434,484</u> | <u>1,234,291</u> | <u>4,123,787</u> | <u>11,622,734</u> | <u>1,133,876</u> | <u>84,760</u> | <u>-0-</u> | <u>-0-</u> | <u>6,692,147</u> | <u>12,941,785</u> |
| Cash and Cash Equivalents at End of Year | <u>\$ 1,298,706</u> | <u>\$ 1,434,484</u> | <u>\$ 5,712,233</u> | <u>\$ 4,123,787</u> | <u>\$ 1,696,026</u> | <u>\$ 1,133,876</u> | <u>\$ -0-</u> | <u>\$ -0-</u> | <u>\$ 8,706,964</u> | <u>\$ 6,692,147</u> |

SUPPLEMENTARY INFORMATION - See Independent Auditor's Report.

VALLEY TELEPHONE COOPERATIVE, INC.
VTCI/VTXT CONSOLIDATING BALANCE SHEETS
DECEMBER 31

| | VTCI | | VTXT | | Eliminations | | Consolidated | |
|---|-----------------------|-----------------------|----------------------|----------------------|-----------------------|-----------------------|-----------------------|-----------------------|
| | 2011 | 2010 | 2011 | 2010 | 2011 | 2010 | 2011 | 2010 |
| Current Assets: | | | | | | | | |
| Cash and cash equivalents | \$ 1,298,706 | \$ 1,434,484 | \$ 1,696,025 | \$ 1,133,876 | | | \$ 2,994,731 | \$ 2,568,360 |
| Telecommunications accounts receivable | 386,705 | 369,628 | 51,213 | 53,219 | | | 437,918 | 422,847 |
| Other accounts receivable | 2,869,806 | 1,951,716 | 60,374 | 59,103 | | | 2,930,180 | 2,010,819 |
| Accrued unbilled revenue | -0- | 40,000 | | | | | -0- | 40,000 |
| Materials and supplies | 5,048,551 | 5,814,911 | 105,584 | 53,884 | | | 5,154,135 | 5,868,795 |
| Prepayments | 904,829 | 1,221,149 | 8,374 | 3,934 | | | 913,203 | 1,225,083 |
| Total Current Assets | 10,508,597 | 10,831,888 | 1,921,570 | 1,304,016 | | | 12,430,167 | 12,135,904 |
| Property, Plant, and Equipment: | | | | | | | | |
| Plant in service | 137,080,810 | 125,100,960 | 9,623,744 | 7,262,354 | | | 146,704,554 | 132,363,314 |
| Plant under construction | 4,302,589 | 9,125,777 | 32,738,564 | 3,061,883 | | | 37,041,153 | 12,187,660 |
| Total Property, Plant, and Equipment | 141,383,399 | 134,226,737 | 42,362,308 | 10,324,237 | | | 183,745,707 | 144,550,974 |
| Less: Accumulated depreciation | 82,618,479 | 79,445,879 | 1,514,202 | 962,114 | | | 84,132,681 | 80,407,993 |
| Net Property, Plant, and Equipment | 58,764,920 | 54,780,858 | 40,848,106 | 9,362,123 | | | 99,613,026 | 64,142,981 |
| Investments and Other Assets: | | | | | | | | |
| Investment in affiliates | 48,465,951 | 47,082,510 | | | \$ (4,262,405) | \$ (4,922,042) | 44,203,546 | 42,160,468 |
| Other assets | 182,185 | 339,104 | | | | | 182,185 | 339,104 |
| Total Noncurrent Assets | 48,648,136 | 47,421,614 | -0- | -0- | (4,262,405) | (4,922,042) | 44,385,731 | 42,499,572 |
| Total Assets | \$ 117,921,653 | \$ 113,034,360 | \$ 42,769,676 | \$ 10,666,139 | \$ (4,262,405) | \$ (4,922,042) | \$ 156,428,924 | \$ 118,778,457 |

SUPPLEMENTARY INFORMATION - See Independent Auditor's Report.

VALLEY TELEPHONE COOPERATIVE, INC.
VTC/VTXT CONSOLIDATING BALANCE SHEETS
DECEMBER 31

| | VTCI | | VTXT | | Eliminations | | Consolidated | |
|--|-----------------------|-----------------------|----------------------|----------------------|-----------------------|-----------------------|-----------------------|-----------------------|
| | 2011 | 2010 | 2011 | 2010 | 2011 | 2010 | 2011 | 2010 |
| Current Liabilities: | | | | | | | | |
| Current maturities long-term debt | \$ 1,319,104 | \$ 1,415,032 | \$ 572,086 | \$ 3,487 | | | \$ 1,891,190 | \$ 1,418,519 |
| Accounts payable | 1,395,171 | 2,001,828 | 4,679,346 | 181,333 | | | 6,074,517 | 2,183,161 |
| Advance billing | 138,752 | 334,505 | 20,726 | 12,106 | | | 159,478 | 346,611 |
| Patronage capital credits payable | 682,381 | 848,751 | | | | | 682,381 | 848,751 |
| Accrued income taxes | | | -0- | 4,087 | | | -0- | 4,087 |
| Other accrued liabilities | 911,780 | 544,701 | 23,902 | 1,212 | | | 935,682 | 545,913 |
| Customer deposits | 23,663 | 27,433 | | | | | 23,663 | 27,433 |
| Total Current Liabilities | 4,470,851 | 5,172,250 | 5,296,060 | 202,225 | | | 9,766,911 | 5,374,475 |
| Long-Term Debt, Less Current Maturities: | | | | | | | | |
| RUS notes | 10,746,199 | 12,017,193 | 14,452,824 | 1,914,832 | | | 25,199,023 | 13,932,025 |
| Capital leases | 28,817 | 55,702 | -0- | -0- | | | 28,817 | 55,702 |
| Total Long-Term Debt, Less Current Maturities | 10,775,016 | 12,072,895 | 14,452,824 | 1,914,832 | | | 25,227,840 | 13,987,727 |
| Other Liabilities: | | | | | | | | |
| Deferred revenue | | | 14,522,707 | 1,820,271 | | | 14,522,707 | 1,820,271 |
| Deferred income taxes | | | 1,110,809 | 624,055 | | | 1,110,809 | 624,055 |
| Advances from affiliates | 15,755,529 | 11,470,461 | 3,124,871 | 1,182,714 | | | 18,880,400 | 12,653,175 |
| Accrued postretirement benefits | 7,910,720 | 5,920,815 | | | | | 7,910,720 | 5,920,815 |
| Total Other Liabilities | 23,666,249 | 17,391,276 | 18,758,387 | 3,627,040 | | | 42,424,636 | 21,018,316 |
| Equity: | | | | | | | | |
| Retained margin | 57,850,020 | 57,719,112 | | | | | 57,850,020 | 57,719,112 |
| Patronage capital assigned | 22,413,618 | 22,014,462 | | | | | 22,413,618 | 22,014,462 |
| Patronage capital assignable | 2,895,995 | 1,788,306 | | | | | 2,895,995 | 1,788,306 |
| Accumulated other comprehensive income: | | | | | | | | |
| Unrecognized postretirement benefit costs | (4,150,096) | (3,123,941) | | | | | (4,150,096) | (3,123,941) |
| Members' equity | | | 4,262,405 | 4,922,042 | \$ (4,262,405) | \$ (4,922,042) | -0- | -0- |
| Total Equity | 79,009,537 | 78,397,939 | 4,262,405 | 4,922,042 | (4,262,405) | (4,922,042) | 79,009,537 | 78,397,939 |
| Total Liabilities and Equity | \$ 117,921,653 | \$ 113,034,360 | \$ 42,769,676 | \$ 10,666,139 | \$ (4,262,405) | \$ (4,922,042) | \$ 156,428,924 | \$ 118,778,457 |

SUPPLEMENTARY INFORMATION - See Independent Auditor's Report.

VALLEY TELEPHONE COOPERATIVE, INC.
VTCI/VTXT CONSOLIDATING STATEMENTS OF OPERATIONS
DECEMBER 31

| | VTCI | | VTXT | | Eliminations | | Consolidated | |
|---------------------------------------|---------------------|---------------------|---------------------|---------------------|-----------------|---------------|---------------------|---------------------|
| | 2011 | 2010 | 2011 | 2010 | 2011 | 2010 | 2011 | 2010 |
| Operating Revenues: | | | | | | | | |
| Local network services | \$ 1,246,837 | \$ 1,198,119 | \$ 113,273 | \$ 101,856 | | | \$ 1,360,110 | \$ 1,299,975 |
| Network access services | 20,407,487 | 18,333,873 | 506,068 | 496,972 | \$ (99,000) | \$ -0- | 20,814,555 | 18,830,845 |
| Long distance network services | 64,625 | 82,102 | 7,567 | 6,701 | | | 72,192 | 88,803 |
| Internet and video services | | | 333,082 | 99,577 | | | 333,082 | 99,577 |
| Grant revenue | | | 5,975 | -0- | | | 5,975 | -0- |
| Miscellaneous | 360,203 | 395,733 | 56,415 | 51,655 | | | 416,618 | 447,388 |
| Less: Uncollectible revenues | 28,977 | (10,422) | (32,592) | (28,729) | | | (3,615) | (39,151) |
| Total Operating Revenues | 22,108,129 | 19,999,405 | 989,788 | 728,032 | (99,000) | -0- | 22,998,917 | 20,727,437 |
| Operating Expenses: | | | | | | | | |
| Plant specific operations | 4,713,404 | 4,880,790 | 225,997 | 130,416 | | | 4,939,401 | 5,011,206 |
| Plant nonspecific operations | 2,791,071 | 2,062,815 | 807,904 | 365,402 | (99,000) | | 3,499,975 | 2,428,217 |
| Depreciation and amortization | 5,273,948 | 4,567,829 | 552,088 | 431,626 | | | 5,826,036 | 4,999,455 |
| Customer operations | 1,662,243 | 1,658,907 | 184,278 | 82,563 | | | 1,846,521 | 1,741,470 |
| Corporate operations | 3,971,396 | 4,232,161 | 168,873 | 182,705 | | | 4,140,269 | 4,414,866 |
| Total Operating Expenses | 18,412,062 | 17,402,502 | 1,939,140 | 1,192,712 | (99,000) | -0- | 20,252,202 | 18,595,214 |
| Operating Taxes | | | | | | | | |
| Income taxes | | | (335,246) | (165,676) | | | (335,246) | (165,676) |
| Other operating taxes | 467,266 | 454,061 | 43,928 | 16,208 | | | 511,194 | 470,269 |
| Total Operating Taxes | 467,266 | 454,061 | (291,318) | (149,468) | -0- | -0- | 175,948 | 304,593 |
| Operating Margin | 3,228,801 | 2,142,842 | (658,034) | (315,212) | -0- | -0- | 2,570,767 | 1,827,630 |
| Nonoperating Margin: | | | | | | | | |
| Interest and investment income | 2,003 | 550 | | | | | 2,003 | 550 |
| Other nonoperating income (expense) | (54,709) | -0- | (1,600) | -0- | | | (56,309) | -0- |
| Income tax benefit (expense) | (45,133) | 7,761 | | | | | (45,133) | 7,761 |
| Total Nonoperating Margin | (97,839) | 8,311 | (1,600) | -0- | -0- | -0- | (99,439) | 8,311 |
| Margin Before Interest Charges | 3,130,962 | 2,151,153 | (659,634) | (315,212) | -0- | -0- | 2,471,328 | 1,835,941 |
| Interest Charges: | | | | | | | | |
| Interest on long-term debt | 600,256 | 653,579 | 303,933 | 6,391 | | | 904,189 | 659,970 |
| Other interest | 46,973 | 6,560 | | | | | 46,973 | 6,560 |
| Capitalized interest | (412,262) | (297,290) | (303,933) | -0- | | | (716,195) | (297,290) |
| Total Interest Charges | 234,967 | 362,849 | -0- | 6,391 | -0- | -0- | 234,967 | 369,240 |
| Net Margin | \$ 2,895,995 | \$ 1,788,304 | \$ (659,634) | \$ (321,603) | \$ -0- | \$ -0- | \$ 2,236,361 | \$ 1,466,701 |

SUPPLEMENTARY INFORMATION - See Independent Auditor's Report.

VALLEY TELEPHONE COOPERATIVE, INC.
VTCI/VTXT CONSOLIDATING STATEMENTS OF CASH FLOWS
DECEMBER 31

| | VTCI | | VTXT | | Eliminations | | Consolidated | |
|---|---------------------|---------------------|---------------------|---------------------|---------------------|---------------|---------------------|---------------------|
| | <u>2011</u> | <u>2010</u> | <u>2011</u> | <u>2010</u> | <u>2011</u> | <u>2010</u> | <u>2011</u> | <u>2010</u> |
| Cash Flows from Operating Activities: | | | | | | | | |
| Net margin | \$ 2,895,995 | \$ 1,788,304 | \$ (659,634) | \$ (321,603) | \$ -0- | \$ -0- | \$ 2,236,361 | \$ 1,466,701 |
| Adjustments to reconcile net margin to net cash provided by operating activities: | | | | | | | | |
| Depreciation and amortization | 5,273,948 | 4,567,829 | 552,088 | 431,626 | | | 5,826,036 | 4,999,455 |
| Amortization of deferred grant revenue | | | (5,975) | -0- | | | (5,975) | -0- |
| Change in assets and liabilities: | | | | | | | | |
| Accounts receivable | (895,167) | 180,450 | 734 | (23,407) | | | (894,433) | 157,043 |
| Prepays | 316,320 | (1,033,536) | (4,440) | (3,085) | | | 311,880 | (1,036,621) |
| Deferred charges | 156,922 | (312,653) | | | | | 156,922 | (312,653) |
| Accounts payable and accruals | 1,227,173 | (130,289) | 48,766 | 157 | | | 1,275,939 | (130,132) |
| Deferred credits | | | 486,754 | 75,066 | | | 486,754 | 75,066 |
| Total Adjustments | <u>6,079,196</u> | <u>3,271,801</u> | <u>1,077,927</u> | <u>480,357</u> | <u>-0-</u> | <u>-0-</u> | <u>7,157,123</u> | <u>3,752,158</u> |
| Net Cash Provided by Operating Activities | <u>8,975,191</u> | <u>5,060,105</u> | <u>418,293</u> | <u>158,754</u> | <u>-0-</u> | <u>-0-</u> | <u>9,393,484</u> | <u>5,218,859</u> |
| Cash Flows from Investing Activities: | | | | | | | | |
| Capital expenditures | <u>(9,194,174)</u> | <u>(13,102,548)</u> | <u>(27,613,301)</u> | <u>(3,888,656)</u> | | | <u>(36,807,475)</u> | <u>(16,991,204)</u> |
| Cash Flows from Financing Activities: | | | | | | | | |
| Payments of long-term debt | (1,393,807) | (1,771,053) | (98,237) | -0- | | | (1,492,044) | (1,771,053) |
| RUS loan advances | | | 12,708,410 | 1,820,271 | | | 12,708,410 | 1,820,271 |
| Grant proceeds | | | 13,204,828 | 1,918,319 | | | 13,204,828 | 1,918,319 |
| Capital credits paid | (2,811,303) | (2,373,191) | | | | | (2,811,303) | (2,373,191) |
| Excise tax refund received | 3,247 | 3,559 | | | | | 3,247 | 3,559 |
| Advances from affiliate | 4,285,068 | 12,383,321 | 1,942,156 | 1,040,428 | | | 6,227,224 | 13,423,749 |
| Net Cash Provided by Financing Activities | <u>83,205</u> | <u>8,242,636</u> | <u>27,757,157</u> | <u>4,779,018</u> | <u>-0-</u> | <u>-0-</u> | <u>27,840,362</u> | <u>13,021,654</u> |
| Net (Decrease) Increase in Cash and Cash Equivalents | <u>(135,778)</u> | <u>200,193</u> | <u>562,149</u> | <u>1,049,116</u> | | | <u>426,371</u> | <u>1,249,309</u> |
| Cash and Cash Equivalents at Beginning of Year | <u>1,434,484</u> | <u>1,234,291</u> | <u>1,133,876</u> | <u>84,760</u> | <u>-0-</u> | <u>-0-</u> | <u>2,568,360</u> | <u>1,319,051</u> |
| Cash and Cash Equivalents at End of Year | <u>\$ 1,298,706</u> | <u>\$ 1,434,484</u> | <u>\$ 1,696,025</u> | <u>\$ 1,133,876</u> | <u>\$ -0-</u> | <u>\$ -0-</u> | <u>\$ 2,994,731</u> | <u>\$ 2,568,360</u> |

SUPPLEMENTARY INFORMATION - See Independent Auditor's Report.

VALLEY TELEPHONE COOPERATIVE, INC.
NOTES TO SUPPLEMENTARY INFORMATION
December 31, 2011

The supplementary information on pages 25 through 28 presents the separate financial statements and consolidation of VTCI and all of its subsidiaries. The supplementary information on pages 29 through 32 presents the separate financial statements and consolidation of VTCI and VTXI only. The VTCI/VTXI Consolidating Statements of Operations does not include VTCI's equity in VTXC's earnings, the subsidiary excluded from this consolidation. Therefore, the consolidated net margin per this financial statement does not agree to the consolidated net margin on page 26. For this reason, the opinion on supplementary information has been qualified. The VTCI/VTXI consolidating presentation is at the request of a lender.

**Independent Auditor's Report
on Internal Control Over Financial Reporting and on Compliance
and Other Matters Based on an Audit of Financial Statements Performed
in Accordance with Government Auditing Standards**

**The Board of Directors
Valley Telephone Cooperative, Inc.
Raymondville, Texas**

We have audited the consolidated financial statements of Valley Telephone Cooperative, Inc. (a Texas corporation), as of and for the years ended December 31, 2011 and 2010, and have issued our report thereon dated March 20, 2012. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting

In planning and performing our audit we considered the Cooperative's internal control over financial reporting (internal control) as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Cooperative's internal control. Accordingly, we do not express an opinion on the effectiveness of the Cooperative's internal control.

Our consideration of internal control was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control that might be significant deficiencies or material weaknesses and therefore there can be no assurance that all such deficiencies have been identified. However, as discussed below, we identified a certain deficiency in internal control that we consider to be a material weakness.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. A material weakness is a deficiency or combination of deficiencies in internal control, such that there is a reasonable possibility that a material misstatement of the Cooperative's financial statements will not be prevented, or detected and corrected on a timely basis. We consider the following deficiency in the Cooperative's internal control to be a material weakness:

Internal controls over financial reporting include those related to the actual preparation and review of the audited financial statements. In order to prepare a complete set of financial statements in conformity with generally accepted accounting principles (GAAP), the preparer must have certain knowledge and expertise.

Cooperative personnel prepare periodic financial statements and other financial information for internal use that meet the needs of management and the Board of Directors. However, the Cooperative does not have internal resources to prepare full-disclosure financial statements required by GAAP for external reporting. For entities of the Cooperative's size, it generally is not practical to obtain the internal expertise to handle all aspects of the external financial reporting. The Cooperative's management is aware of this deficiency and addresses it by obtaining our assistance in the preparation of the Cooperative's annual financial statements. Management reviews and approves the completed statements and distributes them to the users.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether Valley Telephone Cooperative, Inc.'s financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards*.

We noted certain matters that we reported to management of Valley Telephone Cooperative, Inc. in a separate management letter dated March 20, 2012, as required by Section 1773.33 of 7 CFR Part 1773, Policy on Audits of Rural Development Utilities Programs (RDUP).

Valley Telephone Cooperative, Inc.'s response to the finding identified in our audit is described above. The Cooperative's management is aware of the deficiency with regard to financial statement preparation and addresses it by obtaining our assistance in the preparation of the Cooperative's annual financial statements. We did not audit the Cooperative's response and, accordingly, we express no opinion on it.

The material weakness described above was reported in the previous year.

This report is intended solely for the information and use of the Board of Directors, management, others within the organization, the Rural Utilities Service and supplemental lenders, and is not intended to be and should not be used by anyone other than these specified parties. However, this report is a matter of public record and its distribution is not limited.

Curtis Blahely & Co, P.C.

Longview, Texas

March 20, 2012